CPA
Client Bulletin
Smart Tax, Business & Planning Ideas *from your* Trusted Business Advisor(sm)

From Bear Market to Bull Market

May 2013

If the proverbial visitor from Mars had headed our way four years ago, this traveler might have beamed up the news reports from Earth and decided to keep on going to a more promising destination. Why land on a world that apparently was coming to an end? Stock markets had crashed, major brokerage firms were endangered, and the entire financial system seemed to be in jeopardy.

Today, that extraterrestrial traveler would be getting a very different message. Headlines announce that "Mutual Funds Are Breaking Records" and "S&P 500 Closes at Five-Year High." Reports indicate that the average diversified U.S. stock fund is 10% higher than at the previous peak, reached in 2007.

Does this mean that stocks are heading still higher? Or that every bear market will be succeeded by a more powerful bull run? Not necessarily. The future is unknown, and that's certainly true when it comes to investing in stocks.

However, reliable stock market records now go back about 85 years. Those decades have seen booms, busts, recessions, the Great Depression, wars, terror attacks, inflation, rising debt levels, natural disasters, and countless other crises. Yet, the U.S. stock market has continued to reward patient investors, despite this litany of setbacks.

Absorbing future shocks

As mentioned, future investment returns are unpredictable. That said, you can learn some lessons from the recent and distant past. Basic, prudent steps include the following:

- *Diversify*. Holding different types of assets can reduce overall portfolio risk. An investor with a 50-50 portfolio, for example, between stocks and bonds, would have fared better than a 100% stock investor during the 2008–2009

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What's Inside

Rising Revenues

The U.S. reported a federal budget surplus (of $3 billion) in January 2013 for the first time in 5 years. The Treasury received an extra $9 billion in taxes from the expiration of the 2% payroll reduction.

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crash. The diversified investor might have been more likely to stay in stocks, and then benefitted from the subsequent rebound. Adding more asset classes may help to smooth out long-term volatility.

- ***Invest regularly.*** Some financial advisors advocate a strategy of dollar cost averaging, in which you invest a fixed amount periodically, perhaps every month. If you save for retirement by investing in your company's 401(k) plan, you probably are using this approach.

  With dollar cost averaging, you buy more fund shares or stock shares when prices are down, fewer shares when prices are up. Over time, this will lower your cost per share and can lead to higher profits.
- ***Allocate and rebalance.*** You should have a plan for your investing, rather than relying on tips and rumors. Studies show that asset allocation is vital to a successful investment plan—you might aim to have certain portions of your portfolio in stocks, bonds, foreign securities, and perhaps in other asset classes as well.

  From time to time, revisit your allocation and bring it back into line. If you want 60% exposure to U.S. stocks, for example, but a bull market brings that allocation up to 75%, you might sell some stocks and reinvest in other assets to get back to your desired position.
- ***Use tax tactics.*** Selling securities that have lost value can produce capital losses, which offer tax benefits. Those losses can offset capital gains you take, whereas net losses up to $3,000 can be deducted on your tax return each year. Excess losses carry over to future years, where they'll deliver the same tax benefits. Be sure not to reinvest in the security you've sold at a loss within 30 days. That's considered a wash sale, which will deprive you of the tax benefit. ■

New In-Plan Conversions

Although traditional 401(k) plans have become widespread, many employers are adding Roth 401(k) s to their employee benefits. The relationship between these two types of plans is similar to the relationship between traditional and Roth IRAs:

- Traditional 401(k)s are funded largely with pretax dollars. Withdrawals are fully or mostly subject to income tax.
- Roth 401(k)s are funded with after-tax dollars. Withdrawals are completely tax-free after you have had the account for 5 years and reach age 59½.

New opportunity

Under the new tax law (see the *CPA Client Bulletin* for April 2013), you can convert your traditional 401(k) balance to a Roth 401(k). You can do so at any time, as long as your employer offers a Roth 401(k) and the plan documents permit such conversions. The same rules apply for conversions to employer sponsored Roth accounts if you participate in 403(b) or 457(b) plans. Moreover, the federal government's Thrift Savings Plan for federal employees may decide to permit in-plan conversions to its Roth version.

The tax code has allowed such conversions since 2010, but only for people eligible for distributions. That meant conversions generally were available only when a participant left the company, reached 59½, became disabled, died, or when the plan terminated without a similar substitute in place. The new tax law permits current participants to convert without having to meet any of those requirements.

Example 1: Arlene Baxter, age 32, works for ABC Corp., where she participates in a traditional 401(k) plan. ABC also offers a Roth 401(k); in-plan conversions are allowed. Arlene, who has $80,000 in her 401(k), can convert any or all of that $80,000 from her traditional 401(k) to a Roth 401(k).

As mentioned, Arlene creates an opportunity to receive tax-free cash flow in the future when she moves money into the Roth version. Once she reaches 59½, Arlene will be beyond the 5-year mark so she can

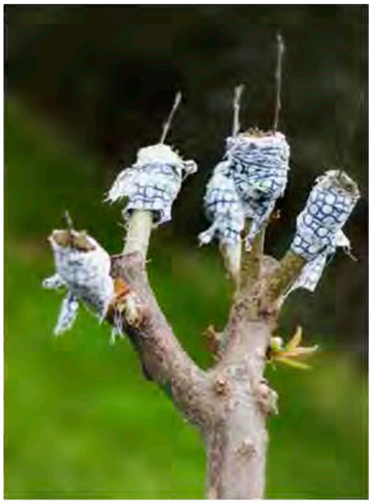
Trusted Advice

Conversion Caveats

- In-plan conversions to Roth 401(k) accounts (unlike Roth IRAs) can't be recharacterized. This decision is irrevocable, and so is the tax obligation you incur.
- The owner of a Roth IRA never has to take required minimum distributions (RMDs), but owners of employer-sponsored Roth 401(k) accounts do not have this advantage. A retired owner of a Roth 401(k) account must take RMDs from the account after age 70½.
- To avoid RMDs, participants can roll their Roth 401(k) accounts to a Roth IRA. However, the period that the rolled-over funds were in the Roth 401(k) account does not count toward the 5-year period for determining qualified distributions from the Roth IRA.

withdraw as much as she'd like without owing tax.

Arlene will pay a price for this future income stream. She'll owe income tax on all the pretax money she moves from her traditional 401(k) to the Roth 401(k). Assuming Arlene's traditional 401(k) is all pretax, she'll add $80,000 to her taxable income for 2013, if she executes a full conversion this year.



Balancing the brackets

Perhaps most important, you should compare your present tax rate to your estimated future tax rate. Ideally, you'll pay tax now at a relatively low tax rate, then take tax-free withdrawals at a time when your tax rate would have been much higher.

The catch, of course, is that converting a traditional 401(k) to a Roth 401(k) will increase your income and may push you into a higher tax bracket in the year of the conversion.

Example 2: Suppose Arlene Baxter is single and expects her taxable income this year, after deductions, to be around $75,000. In 2013, such income puts Arlene in the 25% federal tax bracket, which goes up to $87,850 of taxable income. If Arlene implements a full $80,000 conversion, she'll move into the 28% bracket for the year and owe the higher rate on most of her conversion.

Arlene may not want to pay that much in tax, considering she has no idea of what her income or the tax rates will be when she's age 59½. Therefore, Arlene decides to convert only $10,000 of her traditional 401(k) to a Roth 401(k) in 2013. She will stay in the 25% bracket, so the conversion will increase her tax bill by only $2,500 for the year: 25% of $10,000. Arlene is confident that she will be able to pay that tax without having to borrow from her 401(k) or tap her IRA.

You may decide that taking a series of partial conversions each year is a prudent way to build a tax-free retirement fund. However, the rules on Roth 401(k) plans are complex. For instance, such conversions are irrevocable, so they lack the flexibility of a Roth IRA conversion, which can be reversed. Our office can go over the outlook for an in-plan Roth conversion in your particular circumstances. ■

Using the Work Opportunity Tax Credit

Among the business related provisions of the American Taxpayer Relief Act of 2013, the work opportunity tax credit (WOTC) was extended retroactively, for 2012, and also through 2013. Under the WOTC, employers can receive federal tax credits for hiring and retaining workers from specific groups of individuals that have been designated as facing significant barriers to employment.

Taking credit

If your company hires a worker covered by the WOTC, the tax credit you can claim will depend on the target group of the individual, the amount you pay him or her for the first year of employment, and the number of hours that individual worked. Here are the basic rules. If an employee works

- at least 120 hours, you can claim a tax credit of 25% of the individual's first year wages.
- at least 400 hours, you can claim a tax credit of 40% of the individual's first year wages.

Generally, the maximum tax credit is $2,400. That ceiling applies if you hire food stamp recipients, certain residents of a federally designated Enterprise Community, Renewal Community, Rural Renewal County or Empowerment Zone, individuals in certain vocational rehab programs, ex-felons, or recipients of Supplemental Security Income benefits. If you hire a qualified summer youth employee (i.e., a 16 or 17-year-old who lives in an Empowerment Zone, an Enterprise Community, or a Renewal Community) to work for your company between May 1 and September 15, the maximum tax credit is $1,200.

As explained in the following paragraphs, two other categories of employees have higher maximum WOTC credits.

Hiring veterans

You may be able to claim the WOTC if your company hires a veteran who served on active duty (not including training) in the U.S. Armed Forces for more than 180 days or has been discharged or released from active duty because of a service related disability. That person must not have been on active duty (not including training) for more than 90 days within the 60-day period before being hired.

To get the tax credit, your company must hire a veteran who

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meets certain other criteria, such as being a member of a family receiving food stamps, having a service related disability, or having a lengthy period of unemployment. The maximum WOTC is $2,400 for hiring a qualified veteran unemployed for at least 4 weeks but less than 6 months during the 1-year period ending on the hiring date. The maximum credit is increased to $5,600 for hiring a qualified veteran unemployed for at least 6 months or more during the 1-year period ending on the hiring date. For hiring a veteran who has been on food stamps for at least a 3-month period ending during the 12-month period ending on the hiring date, the maximum credit is $2,400.

Special rules apply to veterans entitled to compensation for a service related disability. If such a veteran is hired by your company within 1 year of leaving the service, your company can receive a tax credit up to $4,800. If such a veteran was unemployed for at least 6 months during the 1-year period ending on the date of hiring, you can receive a credit up to $9,600.

Hiring members of needy families

Temporary Assistance to Needy Families (TANF) is a federal program. If you hire a short-term TANF recipient—any member of a family that received TANF benefits for 9 of the 18 months before being hired—the maximum WOTC is $2,400.

Your company also can hire a long-term TANF recipient. That's someone from a family meeting any of the following conditions:

- The family received TANF benefits during the 18 month period ending on the hiring date.
- The family received TANF benefits for at least 18 months after August 5, 1997. The employee's hiring date must be no more than 2 years after the earliest 18-month period.
- The family stopped being eligible for TANF payments during the past two years because a federal or state law limited the time those payments could be made.

If your company hires an employee from the long-term TANF group, it can take the WOTC over two years.

- If the individual works at least 120 hours in the first year, the employer may claim a tax credit equal to 40% of first-year wages.
- If the individual works at least 400 hours in the second year, the employer may claim a tax credit equal to 50% of second-year wages.

Companies that hire long-term TANF recipients can take a WOTC up to a total of $9,000, over those two years.

To apply for the WOTC, your company must fill out and submit several IRS and Labor Dept. forms. Our office can help you handle the paperwork and claim the tax credit. ■

Veteran Target Group	Maximum Tax Credit
Receives food stamps	$2,400
Entitled to compensation for service-connected disability	
Hired one year from leaving service	$4,800
Unemployed at least 6 months	$9,600
Unemployed	
At least 4 weeks	$2,400
At least 6 months	$5,600

Source: U.S. Department Of Labor

TAX CALENDAR

MAY 2013

May 10

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the first quarter of 2013. This due date applies only if you deposited the tax for the quarter in full and on time.

May 15

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in April if the monthly rule applies.

JUNE 2013

June 17

Individuals. If you are not paying your 2013 income tax through withholding (or will not pay enough tax during the year that way), pay the second installment of your 2013 estimated tax.

If you are a U.S. citizen or resident alien living and working (or on military duty) outside the United States and Puerto Rico, file Form 1040, and pay any tax, interest, and penalties due for 2012. If you want additional time to file your return, file Form 4868 to obtain four additional months to file. Then, file Form 1040 by October 15.

Corporations. Deposit the second installment of estimated tax for 2013.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in May if the monthly rule applies.

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